ESG Investing

SUSTAINABILITY

# How Non-Financial Factors Drive ESG Outperformance

ESG

Capital continues to flow to ESG funds. Consider research from PwC showing that, globally, ESG-related assets under management are expected to increase to $33.9tn by 2026, from $18.4tn in 2021.
Moreover, ESG assets are on track to represent 21.5% of total global assets under management in less than 5 years.

The ability of ESG firms to draw this amount of investment is due, in part, to the fact that investors are increasingly choosing assets that reflect their preference for values-driven companies.

However, some research suggests that capital is rapidly moving to ESG businesses for an additional reason: namely that some non-financial factors, unique to ESG companies, also contribute to their success.

Here we look at the data behind this idea.

**How Do Sustainable Practices Drive Positive Financial Returns?**

An NYU Stern School of Business meta-study analyzing over 1,000 research papers concluded that the majority of ESG-focused funds outperform the broader market.

Within this group was one study from The Journal of Management Studies. The authors of this paper conducted a meta-analysis of 344 primary studies. They determined that there is a link between corporate social responsibility and corporate financial performance. Moreover, they concluded that four key "mechanisms" together explain 20% of this link.

Those four mechanisms are:

1. Mitigating firm risk
2. Strengthening innovation capacity
3. Enhancing firm reputation
4. Increasing stakeholder reciprocation

Let's look at each.

**Risk**

The authors posit that risk management is one key factor underpinning success because ESG companies have a more diverse set of stakeholders and are therefore better able to recognize firm-specific risk. Another reason suggested is the simple fact that ESG firms, by design, are more focused on risks because they have committed to reducing them externally. These businesses aim to create pollution prevention practices, initiate employee health and safety programs, and participate in fair-trade policies.

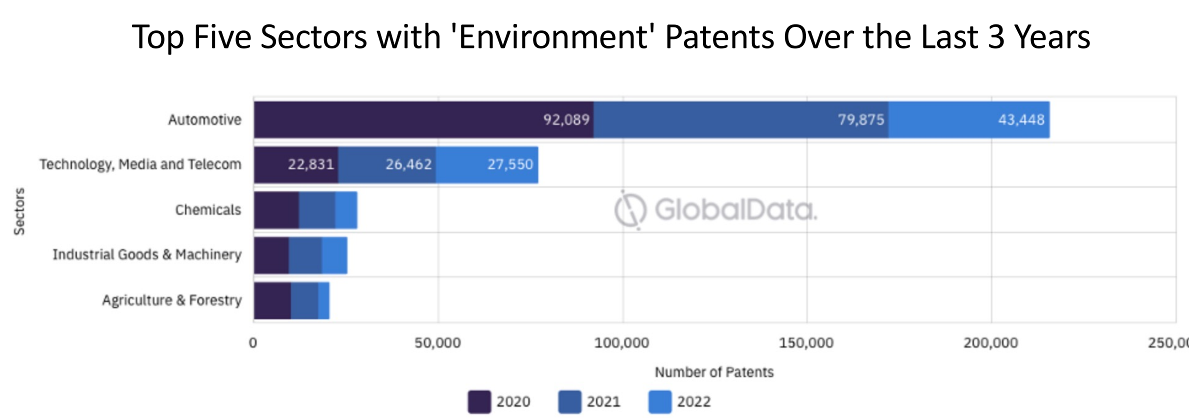
Research from McKinsey expands on the connection between ESG principles and lower risk. They conclude that "better performance in ESG also corresponds with a reduction in downside risk, as evidenced, among other ways, by lower loan and credit default swap spreads and higher credit ratings."

**Innovation**

The authors of *The Journal of Management Studies* also suggest that ESG firms are better innovators because adopting corporate social responsibilities often requires the development of new practices and capabilities.

They also theorize that a commitment to corporate social responsibility drives innovation because the leadership is focused on reducing waste which drives efficiencies and the development of new processes and products.

This theory rings true when combined with research from GlobalData which shows a dramatic increase in patents filed for green technologies in the last decade. Patents in the automotive category lead the group followed by media & telecom, and chemicals.




**Reputation**

Companies understand the reputational advantage that comes from a commitment to ESG practices. Consider that today more than 90% of S&P 500 companies publish some kind of ESG report. The same is true for 70% of Russell 1000 companies. Companies know that investors view ESG companies more favorably.

Research from PwC illustrates this point. They surveyed hundreds of investors globally and found that 75% of the respondents believe that "companies should address ESG issues, even if doing so reduces short-term profitability." Incredibly, nearly half of the survey participants (49%) stated that they would be "willing to divest from companies that aren't taking sufficient action on ESG issues."

The positive reputation enjoyed by ESG firms will only become more beneficial as today's younger, more environmentally-minded generation, ages into their prime investing years.

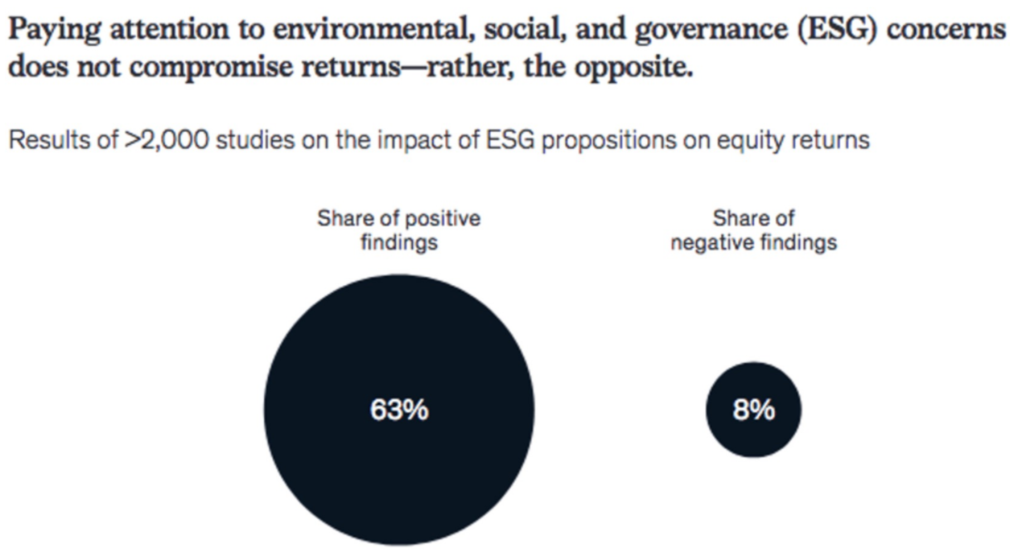
**Reciprocation**

ESG practices create value for stakeholders in several ways. Often, these companies deliver fair pay, a safer work environment, and professional development opportunities. Benefits like these lead to greater satisfaction among employees. This satisfaction leads to greater performance and more buy-in to corporate goals. This dynamic is called reciprocation.

Reciprocation is also important in the context of a firm's relationship with customers and even those that surround the physical location of the business. As the research in the *Journal of Management Studies* explains, "firms in extraction industries often sign community benefit agreements, which are contracts between the firm and local communities stating how firms compensate communities for the social and environmental disruptions they will cause."
Put simply, reciprocation is when the whole is greater than the sum of its parts. By focusing on the interests of others and the environment, the company benefits.

**The Bottom Line**

Many investors know that ESG offers real potential for outperformance relative to non-ESG firms as seen in the below chart. What is less known is the fact that this financial outperformance is often due to a combination of non-financial characteristics that are unique to ESG companies.

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